Internal Revenue Service

memorandum

CC:TL-N-10301-87
Brl:CEButterfield

date: OCT 19 1987

to District Counsel, Atlanta CC:ATL

from: Acting Director, Tax Litigation Division CC:TL

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subject: [redacted]
Non-docketed

This is in response to your memorandum dated August 17, 1987, in which you asked for technical advice in this case.

ISSUE

Whether [redacted] may accrue and deduct amounts reflecting liability for their self-insured worker's compensation plan for the tax year ending [redacted]. 0461.06-01.

CONCLUSION

You have stated that the taxpayer has claimed a deduction for liability with respect to workmen's compensation claims filed and conceded. We have concluded that these claims meet the initial requirement that liability be fixed and established. We cannot determine at this time whether the deductions taken constitute reasonable estimates. Factors to be considered in making this determination are discussed in detail below. The tax year in question in your request is the transitional year under the amendments to I.R.C. § 461(h). Under the transitional rules, the accrual method may apply only to those claims arising before July 18, 1984. Claims falling within the second half of 1984 must be accounted for based on the economic performance requirements of the amended section 461(h); the new section allows deductions for workmen's compensation expenditures as payments are made.

FACTS

[redacted] is currently under examination in the [redacted] District. One of the items being

examined is the reserve amount of $[redacted], representing [redacted]'s accrued liability under its self-insured workman's compensation program. This amount includes approximately [redacted] claims for future medical expenses, future temporary disability payments, and future permanent disability payments. Guidance has been requested on whether it is necessary to audit these claims individually, or if a deduction can be allowed based on a reasonable estimate of the total amount of liability.

LEGAL ANALYSIS

Section 446 creates the rule that taxable income will be computed under the method of accounting by which the taxpayer generally keeps his books. Under this section accrual methods are allowable, subject to the overall limitation of the section that any method used may be disallowed if the Commissioner determines that it does not clearly reflect income. The timing of deductions is governed by section 461, which provides that deductions will be taken in the year which is the proper year under the taxpayer's method of accounting. More detailed requirements for the timing of deductions under the accrual method of accounting can be found in the regulations under sections 446 and 461. Generally, the regulations provide that deductions may be accrued when all the events have occurred which fix the fact of liability, and the amount of the deduction can be determined with reasonable accuracy. Treas. Reg. § 1.461-1(a)(2).

The Tax Reform Act of 1984, Pub.L. 98-369, added the economic performance requirement of section 461(h). Deductions for workmen's compensation expenses must be accounted for as paid if incurred after the effective date of the bill, July 18, 1984. The tax year in question is the transitional year. Thus the transition period rules set forth in Temp. Reg. § 1.461-3T apply. Under the transitional rules, absent an election of one of two alternative methods, the taxpayer will be governed by the cut-off method, which provides that any liability incurred after the effective date of the bill will be accounted for as paid.

There are three considerations presented by the instant case. First, we must determine whether [redacted] meets the first prong of the all events test, that is, whether or not the liability in question is fixed. Then we must determine if the amount of any liability found to be so fixed can be determined with reasonable accuracy. Finally, we must examine what effect the transition rules under the 1984 amendments to section 461 have on a deduction taken in the transition tax year.

In your memorandum you directed our attention to the holdings in Kaiser Steel Corporation v. United States, 717 F.2d 1304 (9th Cir. 1983) and Esco Corporation v. Commissioner, 750 F.2d 1466 (9th Cir. 1985). Your analysis treats both of these cases as if they reach their results purely under the second prong of the all events test, the prong that requires a determination whether amounts of liability can be determined with reasonable accuracy. It is our view that these cases, particularly Kaiser Steel, as the Esco case merely follows it, reach their conclusion in part under the first prong of the all events test, going to the establishment of a fixed liability, and that they are no longer authoritative on this point. In light of the recent Supreme Court decisions in United States v. Hughes Properties, Inc., ___ U.S. ___, 106 S.Ct. 2092 (1986) and United States v. General Dynamics Corp., et al., ___ U.S. ___, 107 S.Ct. 1732 (1987), we feel that the Kaiser Steel decision's first prong analysis must be re-evaluated.

There is a wide spectrum of cases on liability under the first prong of the all events test. One precedent in the former Fifth Circuit, Trinity Construction Co. Inc. v. United States, 424 F.2d 302 (5th Cir. 1970), gives some indication that the Eleventh Circuit (the circuit to which venue would lie in this case) would not necessarily have taken the same liberal view of accrued liabilities that prevailed in the Ninth Circuit even prior to the Supreme Court's decisions in Hughes Properties and General Dynamics. In Trinity the issue was the current deductibility of an obligation to pay insurance premiums on behalf of two former employees. The court held that there was no current liability to make the payments because each of the payments was contingent on the survival of the former employees. Thus all necessary events had not yet occurred to fix the liability.

On the other hand, see Schuessler v. Commissioner, 230 F.2d 722 (5th Cir. 1956), in which the court allowed a deduction for the expense of providing limited service under a five year service agreement. The court reasoned that the possibility that the service (seasonal preparation) would not be performed was very remote, as the seller added a premium to the price of the furnaces that buyers would not have paid without an intention to require performance on the service contract; a possibility as remote as nonperformance under those circumstances could be disregarded for purposes of tax accounting.

The area of workmen's compensation has developed separately from the area of tort liability because of the presence of an underlying statutory obligation. The existence of a statutory compensation structure has been considered dispositive in several cases dealing with accrued deductions. See Harrold v. Commissioner, 192 F.2d 1002 (4th Cir. 1951) (strip mine reclamation required by statute, with a forfeitable deposit in the amount of estimated costs required before mining commenced);

Buckeye International, Inc., T.C. Memo 1984-668 (workmen's compensation); Imperial Colliery Co., Inc., v. United States, 599 F. Supp. 653 (S.D.W.V. 1984) (workmen's compensation). We also have considered cases with statutory underpinnings, such as Harrold, Buckeye, and Imperial Colliery, separately from cases in which the action sounded in tort or contract, such as Trinity, discussed above.

Notwithstanding these Fifth Circuit and workmen's compensation precedents, we believe that the issues in your case must be analyzed with respect to the two recent Supreme Court decisions cited above. At issue in Hughes Properties was a deduction for the accumulated jackpots on progressive slot machines. State law prohibited any reduction of the amounts registered on the machines except through a winning pull of the handle, and required that the odds be set to bring winning within the realm of possibility. As a matter of practice the casinos tended to set odds that resulted in a lapse of up to four years between winning pulls. The Court allowed a deduction for the registered jackpots on these machines at the close of the fiscal year, as state gambling requirements unalterably committed the casinos to pay out the stated amounts. In discussing the unlikely contingencies that might arise to prevent the jackpots from being paid the Court stated at 2097, that "[t]here is always a possibility, of course, that a casino may go out of business, or surrender or lose its license, or go into bankruptcy, with the result that the amounts shown on the jackpot indicators would never be won by playing patrons. But this potential nonpayment of an incurred liability exists for every business that uses an accrual method, and it does not prevent accrual."

In what we view as a clarification of Hughes Properties, the Court subsequently issued its opinion in General Dynamics. This was a case involving a deduction for medical benefit payments by the taxpayer, which was self-insured as to these expenses. The taxpayer had argued that the liability accrued at the time the injury took place whether or not a claim for reimbursement had been filed or approved. Under this theory the taxpayer sought to take a deduction for its reserve for estimates of liabilities incurred but not reported. The Court found that all events necessary to fix liability had not taken place, stating at 107 S.Ct. 1736, that "[s]uch filing is not a mere technicality. It is crucial to the establishment of liability on the part of the taxpayer. Nor does the failure to file a claim represent the type of 'extremely remote and speculative possibility' that we held in Hughes, [citation omitted], did not render an otherwise fixed liability contingent."

Since Hughes Properties and General Dynamics are the leading cases concerning the first prong of the all events test, we must analyze whether [redacted]'s liability for workmen's compensation was fixed in light of these two cases. While

Hughes Properties indicates that the presence of an underlying statutory requirement that an obligation be paid will influence the propriety of an accrual, General Dynamics demonstrates that all the steps necessary to establish legal liability must have taken place before a deduction will be allowed.

In the case of [redacted], only where claims have been filed and conceded will liability be fixed. In Kaiser Steel the court allowed deductions that consisted of estimates of future liability based on injuries, regardless of whether or not any actual claims had been filed. Notwithstanding the manner in which the Ninth Circuit cast their analysis, this was a first prong determination. We believe that General Dynamics establishes that where filing of claims is a condition precedent to a claimant's right to payment, an accrual basis taxpayer cannot deduct an estimate of its future obligations with respect to which claims have not been filed. The first prong of the all events test is concerned with when a liability becomes fixed. The mere fact that it can be statistically demonstrated that a liability is likely to be paid at some point is not sufficient in itself to permit a deduction. General Dynamics, 107 S.Ct. at 1037. General Dynamics indicates that every step necessary to establish legal liability must be fulfilled before a deduction may be taken. Thus, the Kaiser Steel case is of doubtful continued utility. Our position is that where a statute creates liability regardless of fault for injury in the workplace, liability is fixed as soon as a claim is filed and the decision is made not to contest that claim. We will not concede liability at a point earlier than this, under the first prong of the all events test.

In your memorandum, you refer to the Kaiser Steel and Esco cases as allowing the taxpayers to determine their reserves in the aggregate, rather than on a case-by-case basis. Our reading of these cases yields a slightly different result. The reserves were based on estimates (which in turn were based on experience) of the amount of liability that would result from each injury as it occurred. A report was filed each time a covered injury occurred, and an appropriate amount was added to the reserve. Our objection to these cases is not with the manner in which the amount of liability was estimated; the estimates were reasonably accurate. However, the accruals were made immediately after the injuries occurred, before any claims were filed. We regard these cases as incorrect to the extent that they permit liability to accrue before a claim has been made.

The requirement of the second prong of the test that estimates be reasonably accurate requires evaluating taxpayer's medical and accounting practices to be certain that all important factors are used in arriving at individual estimates of liability. See Kaiser at 1308. In the cases of Imperial Colliery Co., Inc. v. United States, 599 F. Supp. 653 (S.D.W.V. 1984) and Buckeye International, Inc., T.C. Memo. 1984-668, actuarial estimates were held to be sufficiently reasonable to

satisfy the second prong of the test. In Imperial Colliery, at 654, the manner of calculating the reserve is discussed. The West Virginia Workmen's Compensation Commissioner makes an award for each claim. The award is then reduced to present value by the Commissioner to derive a "reserve," using a table promulgated by the Commission. The amount of the reserve less the amount already paid was the amount being deducted by the company. Calculations in Buckeye were made on a similar basis.

In the instant case, it must be determined that there was some reasonable basis for the amount deducted for each claim. Factors that contribute to the reasonableness of an estimate are physician's reports on the extent and nature of the injuries, the existence and use of a lost wages formula in the workmen's compensation statute, and, in cases of permanent disability, a statutory limit on the amount of the award multiplied by life expectancy as shown on a reliable actuarial table, such as those promulgated by the Department of Health and Human Services.

You stated in your memorandum that the tax year in question ended [redacted]. You also stated that the taxpayer did not elect one of the alternate transition methods under the Temporary Regulations. As you are aware, under the cut-off method described in Temp. Reg. § 1.461-3T, the taxpayer may only accrue liabilities that were incurred before the effective date of the amended statute, July 18, 1984. It should be verified that the uncontested claims included in the reserve on the books at the end of the year did not include accruals for liabilities incurred after that date. Any such liabilities must be deducted as paid, based on the economic performance standards in the new section 461(h).

Obviously, the tenor of our advice is that all examination should not be suspended. Some exploration into the derivation of the figures in question is necessary, to ensure that the method used to estimate expenses is reliable. We are assuming, for this purpose, that all the claims in question are conceded by the taxpayer. Disputed liabilities do not, in our view, satisfy the first prong of the all events test. Finally, there should be some investigation into whether or not the appropriate transition accounting method has been faithfully employed by the taxpayer. Provided all of these conditions are satisfied, the deduction may be allowed.

If you have any further questions about this matter, please do not hesitate to contact Ms. Clare E. Butterfield, at FTS/566-3521.

PATRICK J. DOWLING

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